Workshop 48
The Trials and Tribulations of Compensation Exclusions

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Compensation under Qualified Plans

- **Compensation applies for following purposes**
  - Determining an EE's allocation or deferrals under DC plan or accruals under DB plan
  - Calculating Code §415 limitation
  - Determining top heavy minimum contribution
  - Performing nondiscrimination tests
  - Calculating ER's deduction
  - To apply minimum gateway contribution
  - To determine HCEs / key EEs

Overview of Compensation

- **Code §415 Compensation**
  - Code §415 Compensation is base measurement upon which plan allocations or accruals are measured
  - 3 main Code-based definitions
    - §§6041/6051 (W-2) Wages
    - §3401(a) Wages for income tax withholding purposes
    - §415 Current includible compensation
- **Code §415 Compensation must be used for:**
  - Applying Code §415 limits
  - Determining top-heavy minimum contributions
  - Determining HCEs / key employees

Overview of Compensation

- **Measured on basis of full 12-month period**
  - Code §415 = limitation year
  - HCE = lookback year
  - Top-heavy = plan year
  - Deductions = ER's tax year
- **Earned Income**
  - Regardless of definition used for employees, use earned income for self-employed and partners
  - Earned income is grossed up for elective deferrals in calculating 415 compensation

Exclusions from §415 Compensation

- **Post-severance compensation generally not included = may never include severance pay**
- **Exception for certain payments paid by later of 2½ months after severance or last day of limitation year**
  - Must include post-severance "regular" compensation
  - May include unused leave cashouts (e.g., sick, vacation, other leave) if would have been paid had EE not terminated
  - May include post-severance payments from nonqualified unfunded deferred compensation plan to extent would be includible in gross income

Exclusions from §415 Compensation

- **Jack terminates employment with ABC Corp on 12/28/15 and receives his last paycheck on 1/10/16. Included in the last paycheck are payments for services, unused vacation/ sick pay, and severance pay.**
  - For what year is the last paycheck included as compensation?
  - Can Jack defer on the amount received in his last paycheck?
  - Will Jack be entitled to an employer contribution based on the amount of his last paycheck?
  - Could the plan be amended to exclude amounts paid after severance of employment?

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Exclusions from §415 Compensation

- **Payments for military service**
  - Heart Act expanded post-severance compensation rules to treat differential wage payments to EEs in military service as compensation under Code §415
    - ER need not provide differential pay but if does = included as 415 compensation
    - EE treated as employed = must receive top-heavy
  - Any contributions made on differential pay need not be taken into account for nondiscrimination testing
- **Disabled participants**
  - Salary continuation paid to EE who is totally disabled may be treated as Code §415 compensation

Deemed §125 Compensation

- **Code §415 compensation includes salary reduction contributions to a cafeteria plan under Code §125**
- **To qualify as salary reduction contribution under Code §125, EE must have right to elect to receive contribution in cash**
- **Some cafeteria plans require EE to enroll in plan if EE is not able to certify that he/she has other health coverage**
  - In those situations, IRC §125 is not applicable and salary reduction contribution for such coverage is technically not included under Code §415

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Deemed §125 Compensation

- **Rev. Rul. 2002-27 allows a qualified plan to include the contributions for such coverage as deemed §125 compensation**
- **Such amounts are treated as deemed §125 compensation only if ER does not otherwise request or collect information regarding the employee's other health coverage**
  - ER may elect to exclude deemed §125 compensation from the Code §415 definition of compensation
  - Allows ERs to treat plan consistently with how treating salary reduction contributions under cafeteria plan

§415 Compensation

- **IRS would prefer if we just use one definition of compensation for all plan purposes, but they didn't write the guidance that way**
- **Nondiscrimination testing is not based on §415 Compensation, but §414(s) Compensation. Strangely, also defined as Total Compensation.**

Allocation / Accrual Compensation

- **Can use any definition of compensation for purposes of determining contributions, accruals or deferrals (even if does not meet 414(s) definition of compensation)**
- **Common exclusions from compensation**
  - Overtime
  - Bonuses
  - Commissions
  - Tips
  - Amounts earned with non-participating related ER
  - Amounts received after termination of employment

§414(s) Compensation

- **Must be used in nondiscrimination tests**
  - Code §401(a)(4) general nondiscrimination test (including cross-testing)
    - Must use 414(s) compensation for applying 3x gateway test
  - ADP/ACP tests
  - Average benefits percentage test under Code 410(b)
- **Must use for allocations under SH plan**
  - Uniform allocation safe harbors under Code §§401(a)(4)-2 & 3.
  - Permitted disparity safe harbor under Code §401(l)
  - SH 401(k) contributions under Code §401(k)(12)

§414(s) Compensation

- **What is §414(s) Compensation?**
  - Start with §415 Compensation and may exclude following safe harbor amounts
    - All elective deferrals (including 401(k) deferrals, 125 cafeteria plan contributions, deferrals under 403(b) or 457(b) plan)
    - All fringe benefits (cash and non-cash), moving expenses, reimbursements, deferred compensation and welfare benefits
    - Amounts paid only to the HCEs
  - *If exclude anything else must do Compensation Ratio Test*

Compensation Ratio Test

- **First classify each employee as Highly or Nonhighly Compensated**
- **Next compute the "compensation percentage" for each employee**
  - Compensation Ratio % = $\dfrac{\text{Plan Compensation}}{\text{Total Compensation}}$
- **Based on the groupings determine averages for the HCEs and NHCEs**

Compensation Ratio Test

- Remember that in determining percentages for the HCEs, amounts over the Code §401(a)(17) limit do not count. Thus, for an individual earning $350,000 if you subtract out a $60,000 bonus, you will use $265,000 for both the numerator and denominator and their ratio percentage is 100%

Compensation Ratio Test

- Compensation Ratio Test designed to assure that HCEs do not benefit more than the NHCEs by more than a "de minimis" amount
- "De minimis" amount is not a defined term, but it is generally assumed within the practitioner community that a difference of 3% or less is "de minimis"
- A difference of more than 3% means that the definition of Compensation being used by the plan is not a definition that satisfies Code §414(s)

Compensation Ratio Test

- **Example - Pass**
  - Plan uses Code §3401(a) Compensation less bonus

Employee	3401(a) Comp	Bonus	Plan Comp	Test Comp	Ratio %
HCE 1	$350,000	$60,000	$290,000	$265,000	100%
HCE 2	$300,000	$50,000	$250,000	$265,000	94.33%
HCE avg.					**97.165%**
NHCE 1	$100,000	$10,000	$90,000	$90,000	90%
NHCE 2	$ 50,000	$ 2,500	$47,500	$50,000	95%
NHCE 3	$ 25,000	$ 250	$24,750	$25,000	99%
NHCE avg.					**94.667%**

Compensation Ratio Test

- **Example - Fail**
  - Plan uses Code §3401(a) Compensation less bonus

Employee	3401(a) Comp	Bonus	Plan Comp	Test Comp	Ratio %
HCE 1	$350,000	$60,000	$290,000	$265,000	100%
HCE 2	$300,000	$50,000	$250,000	$265,000	94.33%
HCE avg.					**97.165%**
NHCE 1	$100,000	$10,000	$90,000	$90,000	90%
NHCE 2	$ 50,000	$ 2,500	$47,500	$50,000	95%
NHCE 3	$ 25,000	$ 1,250	$23,750	$25,000	95%
NHCE avg.					**93.333%**

Flexibility in Compensation

- **XYZ Corp maintains a 401(k) plan for its EEs. The plan defines comp for deferral purposes as gross comp for full plan year.**
  - Joe, CEO of XYZ makes $500,000 per year and defers $18,000 into plan for 2015. Remaining 4 HCEs make over $125,000 and defer between $10,000 and $18,000 into the plan
  - Sally, an NHCE, first becomes a participant in the plan in July of 2015 and defers $2,000 (5% of her $40,000 annual compensation)
  - XYZ declares a bonus twice a year (in June and December). Generally, bonuses are only paid to NHCEs

Example

- **XYZ Corp maintains a 401(k) plan with a 3% uniform PS contribution. For all purposes, Plan compensation is defined to exclude bonuses. XYZ gives all NHCEs a $5,000 bonus and gives all HCEs a 10% bonus (including HCE1 and 2 who earn $350,000 during the year). The following compensation is paid to EEs of XYZ Corp:**

Example

EEs	Total Compensation	Plan Compensation	Comp Ratio
NHCE1	$90,000	$85,000	94.44% [85/90]
NHCE2	$75,000	$70,000	93.33% [70/75]
NHCE3	$65,000	$60,000	92.31% [60/65]
NHCE4	$60,000	$55,000	91.67% [55/60]
NHCE5	$60,000	$55,000	91.67% [55/60]
NHCE6	$55,000	$50,000	90.91% [50/55]
			Avg. = 92.39%
HCE1	$265,000	$265,000	100%
HCE2	$265,000	$265,000	100%
HCE3	$180,000	$162,000	90% [162/180]
			Avg. = 96.67%

Example

- **If definition of compensation fails to satisfy 414(s) definition of compensation, what definition of compensation should XYZ use to determine the ER contribution?**
  - May not use uniform allocation safe harbor unless use 414(s) definition of compensation
  - May the Plan be amended to modify the definition of compensation under the Plan to use Total Compensation?
    - May use TR §1.401(a)(4)-11(g) to retroactively amend definition of compensation to use Total Compensation

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Fixing Comp Ratio Test Failures

- **Easiest solution – change plan definition to not exclude any amounts or exclude only from the HCEs**
  - Best if initial plan design has no compensation exclusions, or at least before the start of the year
  - Next best if amendment is done before the end of the plan year in question.
  - Problem, safe-harbor 401(k) plan with 3% non-elective contribution. Can not amend during the year.
    - Can ER amend SH 401(k) plan to change definition under Treas. Reg. §401(a)–11(g)?

Example

EEs	Total Comp	Plan Comp	3% ER cont.	Allocation%
NHCE1	$90,000	$85,000	$2,550	2.83% [$2,550/$90,000]
NHCE2	$75,000	$70,000	$2,100	2.80% [$2,100/$75,000]
NHCE3	$65,000	$60,000	$1,800	2.77% [$1,800/$65,000]
NHCE4	$60,000	$55,000	$1,650	2.75% [$1,650/$60,000]
NHCE5	$60,000	$55,000	$1,650	2.75% [$1,650/$60,000]
NHCE6	$55,000	$50,000	$1,500	2.73% [$1,500/$55,000]
HCE1	$265,000	$265,000	$7,950	3%
HCE2	$265,000	$265,000	$7,950	3%
HCE3	$180,000	$162,000	$4,860	2.7% [$4,860/$180,000]

- **Does plan satisfy the uniform allocation safe harbor test under Code §401(a)(4)?**

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Fixing Comp Ratio Test Failures

- If change Compensation definition to only exclude bonuses from HCEs, then will pay the 3% on the $30,000 in bonuses paid to the NHCEs or $900. Costing the HCEs approximately $300 each (or one steak dinner for two with one (or two) moderately priced bottles of wine at Bond 45.)
- If do away with bonus exclusion completely = HCE 2 would have an additional $18,000 in eligible compensation and thus a $540 additional contribution

Fixing Comp Ratio Test Failures

- Can stick with a definition of Compensation that doesn't satisfy Code §414(s), but if do then plan can not be safe-harbor and you must perform "general" non-discrimination test. This requires putting every HCE in a test group with every other participant with an equal or higher allocation or accrual rate and seeing if each such test group satisfies coverage testing math.

Example

EEs	Total Comp	Plan Comp	3% ER cont.	Allocation%
NHCE1	$90,000	$85,000	$2,550	2.83% [$2,550/$90,000]
NHCE2	$75,000	$70,000	$2,100	2.80% [$2,100/$75,000]
NHCE3	$65,000	$60,000	$1,800	2.77% [$1,800/$65,000]
NHCE4	$60,000	$55,000	$1,650	2.75% [$1,650/$60,000]
NHCE5	$60,000	$55,000	$1,650	2.75% [$1,650/$60,000]
NHCE6	$55,000	$50,000	$1,500	2.73% [$1,500/$55,000]
HCE1	$265,000	$265,000	$7,950	3%
HCE2	$265,000	$265,000	$7,950	3%
HCE3	$180,000	$162,000	$4,860	2.7% [$4,860/$180,000]

- **Does plan satisfy the uniform allocation safe harbor test under Code §401(a)(4)?**

Example

EEs	Age	Total Comp	Plan Comp	3% ER cont.	Allocation %	EBR
NHCE1	45	$90,000	$85,000	$2,550	2.83%	1.82%
NHCE2	40	$75,000	$70,000	$2,100	2.80%	2.71%
NHCE3	40	$65,000	$60,000	$1,800	2.77%	2.68%
NHCE4	32	$60,000	$55,000	$1,650	2.75%	5.11%
NHCE5	28	$60,000	$55,000	$1,650	2.75%	7.08%
NHCE6	24	$55,000	$50,000	$1,500	2.73%	9.73%
HCE1	50	$265,000	$265,000	$7,950	3%	1.29%
HCE2	50	$265,000	$265,000	$7,950	3%	1.28%
HCE3	45	$180,000	$162,000	$4,860	2.7%	1.74%

- **Does plan satisfy the general nondiscrimination test under Code §401(a)(4)?**

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Example

- **Would the answer change if XYZ plan is a safe harbor 401(k) plan with 3% SHNEC?**
  - Must use 414(s) definition of compensation for SH contributions
    - Would answer change depending on type of plan document (e.g., prototype vs. VS plan)?
  - May plan be amended to modify definition of comp?
  - Must plan provide QNEC to employees to make up missed opportunity to defer on nondiscriminatory definition of compensation?
    - Plan can use any "reasonable" definition for calculating deferrals eligible for SH match
    - No requirement to run compensation ratio test

Plan Design Compensation Exclusions

- **Though it is easier to always use safe-harbor definitions in plan design, it is not unusual to come across plan designs with exclusions from compensation**
- **Excluding all fringe benefits is a safe harbor definition of compensation – no ratio test**
- **Excluding compensation from only the HCEs also safe-harbor – no ratio test**

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Plan Takeovers

- **As both government and independent auditors will tell you, must always look first at the plan's definition of compensation.**
- **If more than one definition, what are the different definitions used for? Not unusual to include elective deferrals for allocation, but exclude for ADP/ACP testing.**

Compensation Failure Issues

- **Takeover a plan with an integrated profit-sharing formula. Under Code §401(l) must use a §414(s) safe-harbor definition. You discover that the plan excludes bonuses and commissions.**
- **Options**
  - Wait a year to take over the plan
  - Amend plan definition to satisfy §414(s)
    - Make sure definition is consistent with plan document (prototype or VS plan)
    - Can ER use 1.401(a)(4)-11(g) to amend plan?
  - General test

Compensation Failure Issues

- **Use Imputed Permitted Disparity**
  - Under these rules, you pretend to integrate the plan by mathematically increasing the actual allocation percentages by the ER's social security contribution percentages. It is a higher allocation for NHCEs who do not earn over the Social Security Taxable Wage Base. HCEs earning over the Wage Base (all except those who are HCEs only by virtue of ownership) will receive a smaller allocation percentage.
- **In most cases may be enough to pass general nondiscrimination test**